



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

January 21, 1998

The Honorable Susan M. Phillips
Chairman
Committee on Supervisory and Regulatory Affairs

On November 24, 1995, we issued our *Report on the Audit of the Board's Applications Processing* (A9504) to the Committee on Banking Supervision and Regulation. While that review evaluated the economy and efficiency of application processing, it excluded application commitments. In August 1997, we began an audit to evaluate the economy and efficiency of the application commitment process and to identify opportunities to reduce regulatory burden. We are pleased to present the results of that audit in our *Report on the Audit of the Federal Reserve System's Application Commitment Process* (A9710), enclosed.

We found that the System has taken action to streamline the application process, reduce regulatory burden, and determine if outstanding commitments are still required. Over time, the effect of these changes should reduce the use and number of application commitments. Notwithstanding the System's efforts, however, we found opportunities to further improve processing efficiency, reduce regulatory burden, and strengthen the controls over the application commitment process and associated resources.

We believe that if the Board were to ensure that commitments are clearly identified when an application is approved, they could be more efficiently tracked and monitored (recommendation 1). We also believe that additional improvements in the application commitment process would be effected if the Director of the Division of Banking Supervision and Regulation (BS&R) were to

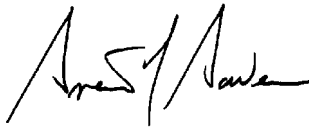
- ensure that all commitments are tracked in a central database (recommendation 2);
- establish monitoring requirements for application commitments (recommendation 3);
- clarify the process for releasing commitments (recommendation 4); and
- eliminate the annual commitment report (recommendation 5).

The Director of BS&R and the General Counsel provided us with a joint response to our draft report (see appendix 1). The response discusses numerous actions taken by the System during the past three years to relieve unnecessary regulatory burden associated with the Board's regulations and decision-making process for applications and notices and outlines specific actions that have been or will be taken regarding three of our five recommendations. Although the response is silent regarding the two other recommendations, senior management in BS&R identified several initiatives during the audit which are designed to enhance the System's ability to identify, monitor, and release application commitments. Implementation of these initiatives, in conjunction with the

other actions discussed in their response, will fulfill the intent of our recommendations. We plan to follow up on implementation of our recommendations and will report any exceptions.

We are sending a copy of this report to each member of the Board and to selected staff. The report is available to the public and a summary will appear in our next semiannual report to the Congress. We are also making the report available on our Internet web page (<http://www.ignet.gov/ignet/internal/frb/oighome.html>).

Sincerely,

A handwritten signature in black ink, appearing to read "Brent L. Bowen". The signature is fluid and cursive, with the first name "Brent" and last name "Bowen" clearly distinguishable.

Brent L Bowen
Inspector General

Enclosure

Board of Governors of the Federal Reserve System

**REPORT ON THE AUDIT OF THE
FEDERAL RESERVE SYSTEM'S
APPLICATION COMMITMENT
PROCESS**



OFFICE OF INSPECTOR GENERAL

TABLE OF CONTENTS

	Page
BACKGROUND	1
Legislative and Regulatory Requirements	1
Commitment Processing	1
Commitment Statistics	2
OBJECTIVES, SCOPE, AND METHODOLOGY	3
FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS	4
ANALYSIS OF COMMENTS	10
APPENDIXES	13
Appendix 1 - Divisions' Comments	15
Appendix 2 - Principal OIG Contributors to this Report	19

BACKGROUND

The Board of Governors of the Federal Reserve System (the Board) seeks to promote the development of a competitive yet stable banking environment through regulation of the structure and expansion of banking organizations. One of the Board's most important regulatory functions involves acting on bank and bank holding company applications involving acquisitions, mergers, nonbanking activities, and certain other changes of control in banking structure. By ruling on applications and issuing regulations, policy statements, and other forms of guidance, the Federal Reserve fosters the public interest and helps preserve a sound banking system.

Legislative and Regulatory Requirements

Various statutes delineate the Board's administrative responsibilities and enforcement powers with regard to application processing.¹ These statutes also describe the factors the Board should consider in approving an application. The Board's Regulation Y delineates the administrative rules for complying with the Bank Holding Company Act of 1956 (the BHC Act) and related statutes. It regulates the acquisition of financial institutions by companies and individuals, defines and regulates nonbanking activities, and sets forth the procedures for securing approval for such transactions and activities. In 1997, the Board adopted changes to Regulation Y that streamlined the process for reviewing proposals from well-run bank holding companies under the BHC Act. The changes eliminated unnecessary regulatory burden and operating restrictions, streamlined the application process, and permitted the System to expedite action on proposals meeting the qualifying criteria set forth in the regulation. The changes to Regulation Y also expanded the regulatory list of nonbanking activities and removed certain restrictions on those activities that were outmoded, superseded by Board order, or did not apply to insured banks that conduct the same activity. The Board's Regulation K provides the rules governing the international and foreign activities of U.S. banking organizations and the U.S. operations of foreign banking organizations.

Commitment Processing

In acting on applications, the Federal Reserve may obtain commitments from an applicant to strengthen the applicant's proposal. The commitments may address statutory, regulatory, supervisory, or other legal concerns and may be unique to a specific transaction or "standard" for similar transactions (such as proposals involving issues of control or joint ventures). Commitments are generally categorized in three ways: (1) those requiring compliance at consummation, (2) those requiring compliance within a certain time frame (generally within six months to two years), and (3)

¹These statutes include the Federal Reserve Act of 1913, the Bank Holding Company Act of 1956 (the BHC Act), the Bank Merger Act of 1960, the Change in Bank Control Act of 1978, and the International Banking Act of 1978.

those deemed to be ongoing. Commitments may be submitted with the application, obtained during application processing, or imposed as conditions in the approval document. Either Reserve Bank or Board staff may obtain commitments during application processing, depending on the timing and issues involved.

Applications are either acted on by the Board or processed by the Reserve Banks or Board staff under delegated authority. The Board's Rules Regarding Delegation of Authority (the Delegation Rules) specify which responsibilities relating to the application process the Board has delegated to the Reserve Banks and to Board Staff. The Board's *Manual on Procedures for Processing Applications and Notifications for Bank Holding Companies and State Member Banks* (the *Manual*) outlines the procedures for processing Board-action and delegated applications.

The Division of Banking Supervision and Regulation (BS&R) has primary staff responsibility for processing applications but coordinates with the Legal Division (LEGAL), the Division of Consumer and Community Affairs (C&CA), and the Division of Research and Statistics. LEGAL also has responsibility for preparing the Board order, which is the document that details the results of the Board's decision on each application. Final approval of applications approved under delegated authority is made in the form of a Reserve Bank approval letter.

Once an application has been approved, Reserve Banks are responsible for monitoring compliance with all commitments. The application approval document may require the applicant to submit periodic reports establishing compliance. Reserve Bank staff may also evaluate compliance during on-site examinations and inspections or through off-site surveillance activities.² The Board or Reserve Banks may release or modify a commitment, depending on the approval level of the original application and the particular issue involved.

Commitment Statistics

During 1995 and 1996, the Federal Reserve System processed 7,910 applications. Of these, 21 percent were Board-action cases and 79 percent were delegated cases. According to reports submitted by the Reserve Banks, there were 4,376 outstanding commitments at the end of 1995 and 4,954 outstanding at the end of 1996. We were unable to verify the accuracy of the statistics pertaining to outstanding commitments, however, because of the different reporting methods Reserve Banks used (see discussion in recommendation 5, page 9).

²The Federal Reserve System has, over the last several years, taken steps to enhance the effectiveness of its examinations and inspections by sharpening its focus on the areas of greatest risk to the soundness of banking organizations. Risk-focused examinations and inspections emphasize effective planning and scoping in order to customize the review to suit the size and activities of financial institutions and to concentrate examiner resources on areas that expose an institution to the greatest degree of risk.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our November 1995 *Report on the Audit of the Board's Applications Processing* (A9504) made several recommendations designed to improve application processing efficiency and timeliness by increasing the use of delegated processing on protested applications and requests for application waivers, reducing the number of name checks performed by the System, and reducing duplication of effort on Board-action applications. Earlier this year, we conducted a follow-up review of the report and found that the Board and Board staff have taken action to improve efficiency and timeliness; accordingly, we have closed the recommendations. In the report we also noted that several legislative initiatives designed to reduce regulatory burden had made, or would make, significant changes to the application process.

We conducted the applications processing audit to evaluate the economy and efficiency of the overall application process; however, we excluded commitment processing from the scope of the review. Although recent Systemwide initiatives will reduce the use of commitments in the application process, we added application commitment processing to this year's audit effort based on concerns identified during the previous audit and the results of our recent audit of the Federal Reserve System's enforcement activities.

Our overall objective in this audit was to assess the economy and efficiency of the application commitment process. Specifically, we wanted to determine whether

- application commitments are clearly defined;
- appropriate levels of resources are used to track and monitor application commitments; and
- opportunities exist to streamline the process or reduce regulatory burden.

To accomplish these objectives, we conducted our fieldwork from August through October 1997. We reviewed commitments entered into for domestic and international applications during 1995 and 1996, including applications approved by the Board and by the Reserve Banks acting under delegated authority. We selected a judgmental sample of twenty-four applications that had been filed with three Reserve Banks. We reviewed Board and Reserve Bank documentation and discussed commitment processing with application and examination staffs. We also reviewed Board and Reserve Bank policies and procedures related to commitment processing, as well as the resources used to track and monitor application commitments. In addition, we interviewed representatives of the nine Reserve Banks not included in our sample to discuss issues raised during our initial fieldwork. Our audit was conducted in accordance with generally accepted government auditing standards.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

Recent changes to the Board's Regulation Y have streamlined the application process and reduced regulatory burden and operating restrictions on bank holding companies. In amending Regulation Y, the Board noted that the application process should not become a vehicle for comprehensively evaluating and addressing supervisory and compliance issues that can be addressed more effectively in the supervisory process. These changes will reduce the number of commitments obtained in the application process. In addition, eight of the Reserve Banks identified initiatives to review outstanding commitments and identify those that can be modified or released or that, in the wake of recent regulatory changes, are no longer required.

Notwithstanding the System's current efforts to reduce the number and use of application commitments, we believe that additional opportunities exist to improve processing efficiency and further reduce regulatory burden. Specifically, the Board needs to ensure that commitments are clearly identified when an application is approved so they can be efficiently tracked and monitored and the Director of BS&R needs to: (1) ensure that all commitments are tracked in a central database, (2) establish requirements for monitoring compliance with application commitments, (3) clarify the process for releasing commitments, and (4) eliminate the annual commitment report.

The potential for a significant reduction in the number of outstanding application commitments and the use of commitments in future processing will, to some degree, affect the amount of resources devoted to implementing our recommendations; however, we believe the recommendations need to be implemented regardless of the volume of commitments. For example, enhancing the process for identifying and monitoring application commitments (recommendations 1 and 3) is consistent with the System's recent move to a risk-focused supervisory approach and will better utilize examiner resources. Allowing the Reserve Banks to process additional requests for relief (recommendation 4) will better align the responsibility for modifying and releasing commitments with the responsibility for monitoring compliance; this change will also allow Board staff to focus on the most important issues. Establishing a mechanism to consistently track commitments Systemwide (recommendation 2), although requiring an up-front investment of System resources, should reduce costs across the System by focusing efforts on developing and maintaining one system as opposed to twelve. A central system would also promote Systemwide consistency and further reduce the need for the annual commitment report (recommendation 5).

BS&R's recent reorganization shifted responsibility within the division for application processing. We met with the new senior management to (1) review our preliminary audit work and (2) get an update on activities related to application commitment processing. Management identified several initiatives to enhance the System's ability to identify, monitor, and release commitments imposed during the application process. These initiatives address several of our recommendations and reflect management's commitment to review and enhance the application commitment process. Because these initiatives were not implemented before we completed our fieldwork, however, we did not fully evaluate their potential effect on the processing of application commitments. Nevertheless, we

encourage the director and General Counsel to implement these initiatives in conjunction with our five recommendations to establish Systemwide expectations for commitment processing that are consistent with the System's current supervisory philosophy.

1. We recommend that the Board ensure that commitments are clearly identified when an application is approved so that they can be efficiently tracked and monitored.

The *Manual* states that the details of a commitment should be set forth in the letter transmitting the Reserve Bank's approval or Board order on the application; the letter should describe in detail the commitment and the agreed-upon timeframe for compliance. However, we found that practice is not consistent with policy. We reviewed twelve Reserve Bank delegated applications and twelve Board-action cases. These applications resulted in commitments ranging in number from one to over 200. In eleven of the twelve Reserve Bank approval letters, the commitments were listed in detail in the approval letters. For the Board-action cases, the approval documents contained a complete list in only three of the cases that we reviewed. For other Board-action cases, the commitments were sometimes partly identified in the Board order or the associated footnotes and sometimes in the transmittal letter. In some cases, however, the commitments were not detailed in either and were referred to in the Board order only in general phrases such as “[t]he Board’s approval is expressly conditioned on compliance with all the commitments made by [the applicant] in connection with the proposal.”

BS&R and Reserve Bank staffs expressed frustration at not always knowing what commitments had been obtained on Board-action cases. They also commented that, because different divisions and staffs may process and obtain commitments at different times during the application process, having them clearly communicated in the approval document or an attachment would ensure that all parties fully understand the commitments relied upon in approving the application. LEGAL staff, on the other hand, expressed concern about providing a specific list of commitments in the Board order or an attachment, since everything in the application was relied upon in reaching the approved decision. In addition, LEGAL staff believe the Reserve Bank staff and the applicant should be familiar enough with the case to identify the commitments from the application files. Board and Reserve Bank staffs also noted that some commitments may be confidential while Board orders are public documents.

Though we acknowledge that the System relies on all parts of the application in approving the transaction, we still believe the Board needs to ensure that application commitments are clearly identified in the Board order, Reserve Bank approval letter, or supplemental document when the application is approved. Listing the commitments is necessary to define clearly—in a single document—the Reserve Banks' requirements for tracking, monitoring, and reporting on the status of compliance and the expectations for the applicant's performance. We recognize that identifying commitments from the application package is not difficult if there are only a few commitments. When an application results in more than 100 commitments, however, we believe that including commitments in the approval documents would be the most efficient method of ensuring that all participants—Board staff, Reserve Bank staff, and the applicant—clearly understand the requirements.

Such a list would also facilitate entry in an automated database for tracking and monitoring purposes. By including the commitments in the transmittal letter or supplemental document, the Board can avoid issues of confidentiality, because these documents are not published and can be redacted, as appropriate, if requested under the Freedom of Information Act.

2. We recommend that the Director of BS&R ensure that all commitments are tracked in a central automated system.

There is currently no Systemwide mechanism to track commitments arising from the applications process. ApLog—the database program used by each of the Reserve Banks as well as the Board to record and track an application from acceptance to consummation—contains a field to indicate whether an application contains commitments. ApLog does not, however, contain any detailed information concerning the commitments. The National Examination Database (NED)—the new Systemwide system, which will maintain supervisory, financial, regulatory, and administrative information on financial institutions—can track "application-imposed conditions" as a type of supervisory action. According to NED development staff, however, this field was designed for use only with application conditions imposed by other regulators, because they report application conditions as a type of supervisory action.

We also found that each of the twelve Reserve Banks has designed its own system for tracking commitments and that several Reserve Banks are designing replacement or updated systems to enhance tracking capabilities. These systems range from manual systems, to simple spreadsheets and word processing files, to sophisticated databases. One Reserve Bank, for example, tracks application commitments in a database that records the text of the commitment, the source of the commitment, and whether the institution is in compliance; the database can also produce a variety of reports used in monitoring the status of commitments. We also found that C&CA has developed a tracking system for consumer-related commitments and that BS&R has created a word processing file for all international commitments; however, neither of these systems can be accessed by other Board staff or the Reserve Banks.

We believe that developing a central tracking and monitoring system for application commitments will benefit the System by eliminating costs for developing and maintaining duplicate systems and by providing a single database for accessing commitment information. Including all application commitments in NED is one option for achieving these objectives; developing an alternate tracking system that will interface with NED is another option. Examination staffs we talked to were supportive of having one system track all supervisory institutional information, including application commitments. A Systemwide system for tracking commitment information would also allow Board staff to access data for informational or reporting purposes or to update commitment-related information when actions are taken by the Board to obtain, modify, or release commitments. In addition, the system would be useful for quickly identifying the current status of application commitments when subsequent applications are filed; Reserve Banks routinely review the status of outstanding commitments during the application approval process. In developing system

requirements, we believe the director should coordinate with the Reserve Banks and other functional areas at the Board to maximize the usefulness of a central tracking system.

3. We recommend that the Director of BS&R establish requirements for monitoring compliance with application commitments.

Reserve Banks have the primary responsibility for monitoring the status and timely fulfillment of commitments. Monitoring may involve the participation of applications, surveillance, or examination staffs. The *Manual* stipulates that the Reserve Banks are responsible for maintaining documentation on the current status of the commitments and should review the applicant's progress toward compliance no less frequently than once a year. In addition, written notification from the applicant of compliance with commitments is required in all cases.

We found inconsistencies in the level of commitment monitoring throughout the System. All Reserve Banks rely upon the examination staff to monitor commitments during the course of examinations and inspections, but practices varied as to which commitments were reviewed and the extent of the review during the examination and inspection process. For example, some Reserve Banks felt that compliance with all commitments should be reviewed during an inspection/examination; others recognized that in a risk-focused approach, some commitments may not be reviewed because of the commitment's inexact nature and/or limited risk. We also found that some Reserve Banks, in addition to monitoring commitments through examinations and inspections, determine compliance through written requests or telephone calls to the institution. This type of monitoring can be quite time-consuming for the Reserve Bank staff and may be perceived as unnecessary regulatory burden by the financial institution.

We believe the Systemwide shift toward a risk-focus supervisory environment calls for an assessment of the current process for monitoring application commitments. Currently, the only guidance provided to the examination staff for reviewing compliance is in Section 2040 of the *BS&R Bank Holding Company Supervision Manual (BHC Supervision Manual)*, which was last updated in 1992. The *BHC Supervision Manual* states that examiners should determine compliance with specific commitments and whether good faith compliance efforts have been made for commitments of inexact nature. We believe that guidance for monitoring application commitments should be updated to reflect the new risk-focus approach and the reduced frequency of examinations and inspections. We also believe the *Manual* should be updated to identify monitoring requirements for each type of commitment and to reflect issues such as which commitments require monitoring, the frequency of monitoring requirements, written notification requirements, and reporting requirements for noncompliance.

4. We recommend that the Director of BS&R redelegate his authority to the Reserve Banks to grant requests for modifying or releasing application commitments, after consultation with Board staff, and clarify the associated procedures.

If an institution proposes to modify or terminate a commitment obtained during the processing of an application, the institution may submit a letter detailing the commitment to be modified or terminated and discussing the factors supporting the commitment modification or termination request (such as an improvement in financial condition). The System processes these requests as it does other applications.

The Board has delegated to the Director of BS&R the authority to approve or deny requests to modify a commitment or condition relied on by the Board or its delegee in acting on an application. There is no specific delegation to the Reserve Banks to act on these requests. However, LEGAL staff stated that the Reserve Banks' authority to act on commitment modification requests is implicit in their authority to act on applications. In addition, the *Manual* states that Reserve Banks may act on commitment termination or modification requests if the commitment was obtained in conjunction with a filing that was approved by the Reserve Bank, and that the request must be forwarded to Board staff only if the commitment was obtained in a filing approved by the Board. However, System staff told us that some standard commitments are considered Board commitments that the Reserve Banks are not authorized to release, even if the commitments were part of an application approved under delegated authority.

We found that different Reserve Banks have interpreted their authority to modify or release commitments differently. One Reserve Bank considers all commitments obtained by the Reserve Bank (whether as part of the original application or in subsequent correspondence between the applicant and the Reserve Bank) to be Reserve Bank commitments, regardless of whether the final application was approved by the Board or the Reserve Bank. Additionally, since the Delegation Rules and the *Manual* are silent with respect to whether Reserve Banks can release commitments absent a specific request from the institution, we found that Reserve Banks have adopted different procedures. For example, some Reserve Banks release commitments without a request from the institution if the Reserve Bank determines that the institution is in compliance (such as during a bank holding company inspection). Other Reserve Banks require institutions to submit a request for relief from all commitments.

We believe that the procedures for modifying or terminating application commitments should be streamlined by modifying the Delegation Rules to allow the Reserve Banks to act on all requests received from the institutions. If the commitments were obtained on a Board- approved application, the Reserve Banks should be required to consult with Board staff before acting on the request. Reserve Banks already have responsibility for monitoring compliance and, under current procedures, may prepare an analysis that goes to the Board to support the institution's request. Delegating additional responsibility to the Reserve Banks would minimize the flow of paperwork while maintaining consistency through required coordination with Board staff. We recognize, however, that some requests may involve policy issues and may need to go to the Board for review. These requests can be handled on a case-by-case basis.

We also believe that the *Manual* should be clarified to allow the Reserve Banks, with sufficient guidance, to modify or release commitments absent a specific request from the institution. Because requests for relief are treated as separate applications, the requests can be time consuming to

process. We reviewed commitment waiver requests for 1995 and 1996 and found that the System took an average of 108 and 41 days, respectively, to process the requests; processing times ranged from 1 to more than 300 days.

We believe that proactively modifying and releasing commitments, when appropriate, would help to reduce regulatory burden and promote goodwill within the banking industry. As discussed above, if the commitments arise in a Board-approved application, Reserve Bank staff should consult with Board staff before notifying the institution of any changes. We also believe that, by providing guidance in situations in which proactively modifying or releasing commitments is appropriate, the director can facilitate and coordinate Systemwide efforts to identify commitments no longer required in light of recent regulatory changes.

5. We recommend that the Director of BS&R eliminate the annual commitment report.

The *Manual* requires the Reserve Banks to submit an annual report concerning commitments entered into as part of the applications process.³ The annual reports provide summary information on compliance activities, narrative details with respect to overdue commitments, and detailed breakdowns by type of commitment (such as capital maintenance requirements) and by the term of the item (for example, fulfilled on consummation). The detailed breakdowns include separate matrixes identifying the number of commitments at the beginning of the year, additions, deletions, and the total number of outstanding commitments at year-end.

We found that the reports have limited usefulness. The Reserve Banks do not use the report internally, although most Reserve Bank staff we spoke to indicated that the report was time consuming to prepare. Board staff stated that the report was used to identify instances of noncompliance; however, there were only four instances of noncompliance reported as of year-end 1996 out of more than 4,000 commitments reportedly outstanding. We did not find any other uses for the report or the detailed matrixes submitted by each Reserve Bank. We also found that parts of the report duplicate separate reporting requirements of C&CA and BS&R regarding consumer and international commitments, respectively.

In addition, we found that information was not consistently reported. As a result, accurate statistics on the number of outstanding commitments were not available. For example, one Reserve Bank did not list ongoing commitments in its report, although this is generally the largest category of outstanding commitments monitored by the Reserve Banks. The Reserve Banks were also not consistent in counting "standard" commitments. Some Reserve Banks counted the commitments individually, whereas others counted a set of standard commitments as one instance. We also found that some Reserve Bank reports were not consistent from one year to the next.

³The *Manual* actually requires a report on all commitments, conditions, and divestitures entered into as part of the application process. Our comments concerning commitments apply equally to conditions and divestitures.

We believe that if Board or Reserve Bank staff require data on the number of outstanding commitments or the status of compliance, these requirements should be included in a Systemwide automation system as discussed in recommendation 2 (page 6). Until such a system is completed, however, the director could require the Reserve Banks to submit a short report identifying any instances of noncompliance.

ANALYSIS OF COMMENTS

We provided draft copies of this report to the Director of BS&R and the General Counsel for their review and comment. They provided a combined response (see appendix 1, page 15) which discusses numerous efforts taken by the System during the past three years to relieve unnecessary regulatory burden associated with the Board's regulations and decision-making process for applications and notices. The response outlines specific actions that have been or will be taken regarding the establishment of a central database, monitoring compliance with application commitments, and eliminating the annual commitment report. We believe these actions are responsive to recommendations 2, 3, and 5.

The response also states that, in general, the System has already put into place improvements and changes necessary to address the substance of all of our recommendations. None of the efforts identified in the response, however, specifically address recommendations 1 and 4. As we acknowledged in the report, actions taken by the System will reduce the number of outstanding commitments and the use of commitments in the processing of future applications. Notwithstanding these efforts, we continue to believe that clearly identifying commitments when an application is approved (recommendation 1) is a simple, yet efficient, method of ensuring that Board staff, Reserve Bank staff, and the applicant clearly understand the requirements established when action is taken on an application. We also believe that allowing the Reserve Banks to process additional requests for relief (recommendation 4) will better align the responsibility for modifying and releasing commitments with the responsibility for monitoring compliance.

At the conclusion of our audit, BS&R senior management identified several initiatives designed to enhance the System's ability to identify, monitor, and release commitments. These initiatives include (1) developing a mechanism to better identify outstanding commitments and conditions for the use of Federal Reserve examiners and applicants, and (2) reviewing the current authority to approve or act on certain applications-related matters, such as commitment relief. Implementation of these initiatives, in conjunction with the other actions discussed in the staff's response to our report, will fulfill the intent of our recommendations.

APPENDIXES

(A9710)

Appendix 1 - Divisions' Comments

Appendix 1 - Divisions' Comments

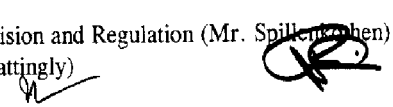
Appendix 1 - Divisions' Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMO

DATE: January 9, 1998

TO: Mr. Snyder

FROM: Division of Banking Supervision and Regulation (Mr. Spillencohen) and Legal Division (Mr. Mattingly) 

SUBJECT: Response to Draft "Report on the Audit of the Federal Reserve System's Application Commitment Process"

The Division of Banking Supervision and Regulation and the Legal Division have reviewed the draft "Report on the Audit of the Federal Reserve System's Application Commitment Process" prepared by the Inspector General's Office. The draft Report is based on a review of a sample of commitments made in connection with domestic and international applications processed in 1995 and 1996, and included applications approved by the Board as well as applications reviewed by the Reserve Banks acting under delegated authority. The draft Report makes recommendations with the goal of improving efficiencies and reducing regulatory burden.

The Division of Banking Supervision and Regulation and the Legal Division appreciate the efforts reflected in the draft Report, but believe that the Report does not adequately take account of the significant changes that have already occurred--especially those that were made in 1997--and the efforts currently underway to change the role of commitments in the applications and supervisory processes. The Division of Banking Supervision and Regulation and the Legal Division have worked closely with the Board during the past three years to relieve unnecessary regulatory burden associated with the Board's regulations and decision-making process for applications and notices. As a result, the Board has eliminated a significant number of restrictions governing the activities of bank holding companies and streamlined the approval process.

Appendix 1 - Divisions' Comments

-2-

These actions have resulted in elimination of significant numbers of commitments and the automatic grant of relief to companies subject to many commitments.

These actions include:

1. A comprehensive revision of Regulation Y that broadened the scope of permissible nonbanking activities and eliminated dozens of commitments relating to these activities.
2. A comprehensive revision of the Board's section 20 firewalls governing the securities underwriting activities of bank holding company affiliates. The elimination of nearly 30 firewalls in this single action eliminated approximately 25 percent of the outstanding commitments estimated in the draft Report.
3. A comprehensive review of commitments governing joint ventures, domestic acquisitions by foreign entities and noncontrolling investments to standardize and reduce the number and type of commitments obtained in these areas.
4. The implementation of a new Board policy that the applications process should not be used to evaluate and address supervisory and compliance issues that can be better addressed through bank examination and supervisory processes. This decision reduced the need for obtaining in the applications process commitments that address supervisory matters.
5. The implementation of a new risk-focused supervisory program that establishes a supervisory framework for reviewing and monitoring a banking organization's principal risks and its internal systems and processes for managing and controlling these risks.
6. The publication of proposed changes to Regulation K that include reductions in the burdens and commitments governing activities of U.S. banking organizations abroad and the domestic activities of foreign banks.

Appendix 1 - Divisions' Comments

-3-

In an effort to implement these changes uniformly, each of these actions was accompanied by the preparation of specific written guidance to the Reserve Banks regarding the policy changes. In addition, Board staff organized and participated in training sessions and conference calls with relevant System staff designed to communicate and explain the changes.

The implementation of the risk-focused examination program, realignment of the applications process to a more transaction focused process and elimination of significant numbers of commitments have also caused a review of the priority that should be given during examinations and inspections to reviewing an institution's compliance with commitments. The Division of Banking Supervision and Regulation in coordination with the Legal Division and Reserve Bank examiners and supervisors are working together to decide whether and to what extent commitment compliance should be reviewed in the examination process and the most effective method for monitoring commitments that warrant such review. These staff are also working together to assure that these decisions are communicated effectively throughout the System and uniformly applied.

As a result of the actions described above, the System, through the efforts of the Division of Banking Supervision and Regulation, the Legal Division, other interested Divisions and the Reserve Banks, has already put into place improvements and changes necessary to address the substance of the draft Report's recommendations. With regard to Recommendation 2, which involves the establishment of a central data base, the staffs of the Division of Banking Supervision and Regulation and the Legal Division will work together to evaluate the need for such a data base in the current risk-focused bank supervision environment, taking into account the costs of creating and maintaining such a data base and the usefulness of alternatives, including existing data bases such as NED. Finally, staff of the Division of Banking Supervision and Regulation will, in accordance with Recommendation 5, eliminate the currently required report from the Reserve Banks regarding commitments because the report no longer provides information that is useful in the present bank supervision environment.

The Division of Banking Supervision and Regulation and the Legal Division believe that the efforts taken in the past three years are significant and have fundamentally changed the role commitments play in the supervisory

Appendix 1 - Divisions' Comments

-4-

process, have reduced regulatory burden and have improved efficiency. The staffs of both Divisions remain committed to continuing efforts to reduce unnecessary regulatory burden, to maintaining communications with the Reserve Banks regarding Board policies, and to assisting the Reserve Banks in implementing Board policies in the applications and examination processes.

Appendix 2 - Principal OIG Contributors to this Report

Bill Mitchell, Auditor-in-Charge

Nancy Perkins, Senior Auditor

Patty Kelley, Audit Manager

Harry Jorgenson, Counsel to the Inspector General

Barry Snyder, Assistant Inspector General for Audits